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SUBJECT: RUSSIAN OIL PRODUCTION: STAGNATING UNDER HEAVY TAX BURDEN

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SUMMARY

¶1. (SBU) The rate of growth in Russian oil production has dropped significantly in recent years and output may actually decline in 2008. Production growth has slowed as declines in output from existing fields have not been adequately replaced by production from new fields. Investment in these "greenfields" has been hampered by an onerous tax regime that takes 90% of the revenues above $25 per barrel of exported crude. Industry insiders believe that the GOR will have to use tax relief to boost production. The GOR recently proposed some limited upstream tax relief but most analysts believe these are insufficient to restore growth. With Russian production stagnant or declining and domestic demand rising, global markets are likely to see a loss of Russian crude oil supplies in the near term. End Summary.

SLOWING GROWTH

¶2. (SBU) Worries about Russian oil output have finally hit the headlines with a spate of recent articles in the Wall Street Journal and elsewhere noting slowing growth. This follows months of analysts' projections that Russian oil production was stagnating. In fact, this year may be the first in a decade to see Russian oil production decline. Russia's oil production of 9.76 million barrels per day (mbd) in March 2008 is down more than one percent from a year ago. Moreover, all major oil companies except Rosneft are predicting declining output from their companies in 2008.

¶3. (SBU) After the fall of the Soviet Union, Russian production initially plummeted amid economic collapse but then rebounded dramatically as privatization took hold and Western management practices and technology were implemented. In the early years of the decade oil production was growing at a double digit rate every year, from 6.5 mbd in 2000 to 9.2 mbd in 2004. In 2005, however, with the government increasingly interfering in the sector, growth began to slow. Investment lagged and output from old and declining fields wasn't adequately replaced by new production. The rate of growth dropped to about 2% per year from 2005 to 2007.

TAXES TO BLAME

¶4. (SBU) Although excessive state control in the sector remains an obstacle to increased production, most industry insiders with whom we have spoken point to the tax regime as the major impediment to boosting output. Russia has some of the largest untapped reserves in the world. However, most of its current production is from old fields that have already peaked and begun to decline, even with the successful application of new technologies. The resources that hold the key to Russia's future production lie largely in unexplored areas, including East Siberia and offshore. Tapping these reserves requires billions of dollars of investment in exploration and production (E&P) as well as in physical infrastructure such as roads. However, the country's onerous tax structure severely limits the potential return on the investments required to exploit new fields.

¶5. (SBU) An analysis British Petroleum (BP) shared with us shows that when the price of the Urals blend (Russian oil mix) is above $25 per barrel (it is currently about $107 per barrel), the effective marginal tax rate of the combination of the Mineral Extraction Tax (MET, 22%), the export tariff (65%), and the tax on profits (3.1%), is over 90%. That means that a rise of $10 in the oil price adds only $1 per barrel to an oil company's bottom line and $9 to the state's coffers -- indeed, this structure is the main source of the huge cash surplus the Russian government has socked away in recent years. Given the already-challenging commercial uncertainties involved in exploiting Russia's oil and gas

resources, this tax burden is a major disincentive to new production.

¶6. (SBU) A senior executive at one major Russian producer, explaining the fiscal policy behind the oil tax regime, told us the government is "just out to maximize revenue," with little regard for the industry as a whole. An oil analyst at a major investment house bluntly said the system was created "to screw the oligarchs," and that now the government doesn't really know how to fix it. Our contacts at another major Russian oil company were more generous, observing that the politicians writing the laws simply do not understand the complexities of oil industry economics and have created a system that is "not well thought out." They added that taxing production is easier than taxing profits, and it provides a more reliable revenue stream for a government distrustful of industry's inclination to pay taxes fairly.

¶7. (SBU) Given maturing fields, rising costs, and high taxes, oil producers face a grim future without enlightened government actions. Industry sources specifically point to the rapidly rising costs of exploration and production inputs -- from engineers to steel to management talent -- and a weakening dollar as squeezing margins and making it more difficult to profit under the tax regime in Russia. For example, one major oil company shared with us an internal analysis showing that given current cost inflation and the tax structure, their profit per barrel at a given price declines to zero in just five years. And the head of a small international joint venture here told us that while small investments in existing fields can still pay off, the tax structure is a project killer for the major long-term investments needed to develop greenfields.

TAX REFORM?

¶8. (SBU) Under pressure from oil companies, most prominently Lukoil and Rosneft, the government is considering steps to ease the tax burden. Under the current tax regime, the MET is applied at a Urals' price above $9 a barrel; in March, the

GOR announced a proposal to raise that threshold to $15. The industry and the investment community welcomed the proposal, which industry insiders tell us is likely to be implemented. However, most also deemed the measure inadequate and question whether it reflects government understanding of the depth of the problem. One industry contact speculated that the Ministry of Finance may have only agreed to the proposed MET cut in acknowledgement that the rate should "at least be adjusted for inflation".

¶9. (SBU) More promising from the industry's point of view, was the announcement in April by Minister of Industry and Energy Viktor Khristenko that the government is planning additional tax relief, possibly including a further cut in the MET rate. However, despite these inklings of understanding by the state, the debate over tax relief is continuing. Easing the burden on big corporations with large profits remains politically unpalatable. A Duma leader was recently quoted in the press as opposing proposed tax cuts because "oil companies are doing fine." One TNK-BP economist told us the industry needs to simplify the complicated situation to a few key points so politicians and the public can understand what's at stake.

STAGNATION TO CONTINUE

¶10. (SBU) Absent fundamental tax reform, industry insiders and analysts tell us significant production growth will not resume anytime soon, and that output may indeed begin to decline. Moreover, even if the government implements reform this year, there will be a lag before it begins to affect production. A senior executive of a major international oil company told us that with production at existing fields beginning to decline, "it will be hard to bring new fields online quickly enough to replace those lost barrels." Leonid Fedun, the Executive Vice President of Lukoil, Russia's

second largest oil company, summed up the situation when he told us he didn't foresee much change in production for the "next few years."

¶11. (SBU) Russia is the second largest oil producer in the world after Saudi Arabia. Even minor declines in output take large absolute quantities of oil off the world market. A 1% drop in output in Russia means roughly 100,000 fewer barrels per day of oil for global consumers. Moreover, with a booming economy driving rising domestic demand, Russia's exportable surplus can be expected to decline without production increases. Given the obstacles posed by the tax regime as well as the long lead times for projects capable of significantly altering this reality, the world could see a meaningful loss of supply if Russian oil production continues to stagnate and even greater loss of supply if it begins to decline.
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